The True Cost of Merchant Cash Advance Programs

While traditional merchant cash advance programs have been around for some time, they have become increasingly popular with telecommunications companies over the last several years.

How Merchant Cash Advances Work

Merchant cash advance loans are provided based on monthly credit card receipts. The lender simply directs the cash flow into a bank account that they control and typically advances a set amount based on 3 to 4 months of credit card transactions.

However, in the last few years, there has been a change in many merchant cash advance programs. A wave of new companies has arisen who will look at the previous 6 to 12 months of bank account activity and determine a loan amount as a percentage of those collections.

The process is fairly simple. A telecommunications company submits their bank statements, tax returns and personal financial statements from the principals of the company. The loan application process usually takes about a week. If approved, as most loans are, the funding happens within a day or two after the documents are signed.

Breaking Down The True Cost

Borrowers of merchant cash advance loans are often unaware of the true cost of funds to which they are receiving. The loan agreements have a tendency to be confusing, and one could argue that this is by design in order to hide extremely high rates that can be in the triple digits.

These lenders will structure their contracts so that they are purchasing or factoring a company's “future cash receipts”. For example, they will buy $150,000 at a 1.4 discount. That means the advance will be $107,143. The interest that will be earned by the company is $42,857. Assuming the term of this arrangement is 9 months, they will ACH the appropriate principal and interest either daily or weekly out of the company's bank account. That means that the average outstanding loan balance on $150,000 is $53,507. So the interest rate appears to be 80%, but it is actually higher because the term is only 9 months. The actual interest rate is 106.67%. See the table below to see how that works.

Future cash payments being purchased	$150,000
Discount	1.4
Advance	$107,143

Cost of Funds	$42,857
Average outstanding advance	$53,571
Annualized interest rate	80.00%
Term of loan in months	9
True cost of funds (80% divided by 9 x 12)	106.67%

So why would anyone participate in one of these loans?

Many business owners are enticed by the ease of qualification and quick approval process, and because the agreements can be confusing they may not realize the exorbitant price they are paying. Timing could also be critical if, for example, the business is facing a tax lien. Other companies may be willing to pay a premium in order to take advantage of an opportunity that makes the high pricing worthwhile.

Alternatives to Merchant Cash Advance Programs

- **Traditional Factoring -** Some traditional factoring companies will advance on a telecommunication company's accounts receivable, and in some cases, will offer a higher advance amount than a merchant cash advance lender. The effective cost of funds varies but typically it is under 20%. The approval process is generally weeks, not months.
- **Asset Based Loans** - An asset based lender is another lending alternative. These lenders will review a company's assets, determine their value and will lend a percentage of that amount. The loan could be issued as either a line of credit or as a term loan. Rates for these

type of loans are usually in the low to mid-teens with an approval process that ranges from 3 to 6 weeks in most cases.

At Thermo Credit, we believe that understanding the true cost of funds is an important step in the lending process and that a telecommunication company should consider all types of funding options available to them to help their company grow.